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SUBJECT: ROMANIA: ROMGAZ TRIES TO ADAPT TO CHANGING ENERGY MARKET

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SUMMARY

¶1. (SBU) One of the top two gas producers in Romania, state-owned Romgaz, echoed in a November 20 meeting the previous public statements by OMV/Petrom and other private players on the domestic market that the regulated price of domestic gas suppresses production in Romania. Until now Romgaz has maintained a public silence on this point. Concerning investment plans, Romgaz hopes to obtain additional on- and off-shore exploration concessions, develop new underground gas storage areas, and begin producing electricity. The proposed liquefied natural gas (LNG) terminal in Constanta also ranks high among Romgaz's priorities. End Summary.

REGULATED DOMESTIC GAS PRICES IMPEDE PRODUCTION

¶2. (SBU) The regulated price of domestic gas is among the biggest challenges facing Romgaz. While gas imported from Russia is sold at one of the highest prices paid by any European country (currently 280 USD per thousand cubic meters (mcm)), by regulation domestically produced gas may be sold for no more than 160 USD per mcm. In a November 20th meeting with EconOff, Romgaz Deputy Director General Lucian Stancu stated that the company has developed economic models to show the correlation between gas prices and the amount of gas that could be produced domestically, but the Ministry of Economy has never even asked for the information. Stancu admitted that Romgaz was uninterested in exploiting smaller and/or unconventional reserves (i.e., gas found in coal beds, shale formations, or other non-conventional reservoirs) given the expected low rate of return on investment. These fields would only become economical if either the gas could be exported or if the domestic wellhead price could approach the Russian import price, neither of which yet seems feasible.

¶3. (SBU) While Romgaz could in theory export domestic gas, the lack of infrastructure to do so and political pressure to use Romanian gas at home make this unlikely. Instead, Romgaz would like to tap into foreign markets by exploring outside of Romania's borders. To this end, the company has recently developed joint ventures to explore for gas in Slovenia and Poland. Romgaz also hopes to develop activities in the Caspian Sea, building on the expertise gained in the region when it was part of the Soviet Union. In private, Romgaz officials hope the European Commission will force Romania to eliminate its regulated gas pricing system, but Stancu admits that this would be politically unpopular, especially among poorer consumers in the midst of a severe recession.

LOOKING FOR GAS IN NEW PLACES

¶4. (SBU) Romgaz is well aware of the country's potential for unconventional gas and that current technology could increase yields from existing fields. At the same time, Romgaz points to the high

costs it faces in the application of new technology. According to Stancu, insufficient infrastructure results in well services costing at least twice what they would elsewhere; the price Romgaz pays to drill one well would easily cover drilling two wells in the United States. Negotiating with service companies to lower fees in return for higher volume is a tactic that Romgaz has attempted, so far without notable success.

¶5. (SBU) Offshore, Romgaz plans to bid for exploration and production licenses in blocks near Romania's maritime border with Ukraine in the bidding round that the National Agency for Mineral Resources will conduct in May 2010. Lacking the technical expertise for offshore operations on its own, Romgaz is contemplating a joint venture with an international oil company but has not decided whether it will seek the joint venture before bidding or after obtaining the concession. Romgaz will also likely bid on the few remaining onshore blocks in the upcoming bid round.

GAS PRODUCER BECOMES ELECTRICITY PRODUCER?

¶6. (SBU) Romgaz presents a clear case of regulations driving rent-seeking market behavior. According to Stancu, Romgaz is in the process of taking over a gas-fired power plant in Iernut (central Romania) under a debt-for-equity swap arrangement with state-owned thermal power producer Termoelectrica. The acquisition is economical due to the huge disparity between domestically regulated gas and unregulated electricity prices. Per kilowatt hour of energy, electricity sells at double the cost of gas, according to Stancu. Romgaz plans to use this plant as a peak-load generator to cover the electricity deficit in central Romania. Romgaz believes it can avoid the regulatory requirement that gas used for power generation be part of a blended basket comprised of both domestic and imported gas. If Romgaz integrates the plant onto its balance sheet as an asset and uses some of the electricity produced for internal consumption, it is not bound by the basket rules and can

sell excess production (which will be most of what the plant produces) to the market.

¶7. (SBU) With regard to the long-standing proposal to consolidate state-owned energy companies into one or two integrated "national energy champion(s)," Stancu believes Romgaz has enough political clout to remain independent of the new company. State-owned, but profitable and independently operated from the city of Medias 208 miles from Bucharest, Romgaz has little interest in subsidizing inefficient and loss-making producers elsewhere in the state-dominated energy sector. Despite initial plans to include Romgaz in the energy holding company, Stancu said he had received assurances from the Ministry of Economy that this proposal was definitively off the table.

LNG IMPORTS AND MORE GAS STORAGE ARE FUTURE GOALS

¶8. (SBU) While unclear on the precise economics, Stancu confirmed that diversifying Romania's gas import capabilities to include an LNG option made sense. U.S. contractor Granherne is conducting an LNG import terminal feasibility study for Romgaz with funding from the U.S. Trade and Development Agency (USTDA). To avoid problems with Turkey over importing gas through the crowded Bosporus Straits, Romgaz hopes the terminal will be fed by Caspian Sea gas transported across the Black Sea, compressed in Georgia or brought via tankers with onboard compression capability. Romgaz believes that using LNG to feed electric power plants could help make the economic case that the terminal is warranted. If the LNG could be sold for less than pipeline Russian gas, this would also inject a new element of competition into the market. As additional cross-border interconnections are built, LNG imported into Romania could also be used for gas swaps with neighboring countries.

¶9. (SBU) Romgaz also wants to improve its gas storage capacity. Over the last several months, Romgaz has invested in existing underground facilities to improve the gas extraction rate from 20 million cubic meters (MMcm) per day to 25 MMcm per day. While Romania had enough gas stored during the Russian supply cutoff last January to last through the winter, the limit on extraction capacity

still stressed the system and forced cutoffs to some industrial consumers. Romgaz currently has 2.9 billion cubic meters in underground storage, part of which will be drawn down over the course of the winter. The company is also studying a project with Gazprom to develop an underground storage facility in Margineni, in eastern Romania.

COMMENT

¶10. (SBU) Romgaz's shares of both the domestic market and production have declined compared with Petrom ever since the latter was acquired by Austrian-owned OMV. While Romgaz has remained profitable, Petrom's increased nimbleness as a private company has undermined Romgaz's position as the clear market leader. Despite this, the Romanian Government is broadly opposed to further privatization in "strategic" sectors like energy, especially when it comes to crown jewels like Romgaz. While this ensures that important strategic priorities like Nabucco and Black Sea LNG remain important, ultimately it means that Romanian consumers must pay a price for over-regulation, underinvestment, and relative inefficiency in this state-owned sector. End Comment.

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